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Opinion

ESG Ratings: Ideological or Just Logical?

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ESG-based investing is clearly a hot topic right now. Masmovil (Spain's fourth-largest telecoms company) recently included a margin ratchet based on an ESG rating as part of its €1.7 billion debt package. Atlantica Yield plc (the sustainable total return company that owns a diversified portfolio of contracted assets in the energy and environment sectors) announced it has signed its first guarantee facility with pricing based on ESG ratings. And Drax has also signed up an ESG facility where the margin adjusts by reference to carbon emission targets.

Investing in these deals or other green bonds or a company with good green credentials may give investors that warm, fuzzy feeling one might get from a high five with Greta Thunberg, but is that all? Could this miss the point of some of the key benefits that ESG ratings can provide?

Of course, ESG ratings will take account of carbon emissions/footprint, environmental impact on wildlife and natural resources, pollution, and the waste management and recycling approach of the business in question. But these areas are just the E of ESG. The S, the social element, will look at how the workforce is managed, trained and developed; health and safety records and approach; and how the company manages risk in relation to product safety and quality (and therefore liability). The G, the governance element, will look at things like board diversity, executive pay, ownership and control systems (i.e., are there checks and balances in place, or are there strong personalities driving the bus — potentially in the wrong direction); accounting standards and rigor; behavior and culture (ethics); transparency and information flows; and approach to compliance standards regarding competition and anti-corruption.

All of these factors feed into a qualitative picture of a business and provide a snapshot of the level of sophistication and style of management; the approach to the risks and regulations they need to grapple with particular to their sector or which are being introduced; how effectively they manage those risks compared to their peers; and therefore ultimately to what extent they have a competitive advantage or at least are not disadvantaged. So an ESG-based analysis will get in behind the bald facts presented in financial statements and provide a more qualitative than quantitative view. The ESG ratings seek to turn the former into the latter.

Of course there is a way to go in terms of investors' getting comfortable with the output of these ratings and getting to grips with the relative impact of one ESG rating over another. Exponential technological improvements and sophistication of data processing power, and therefore the sheer number of variables that can be analyzed and quantified, can only help build investor confidence in this area though.

So while ESG-related investing can be seen as an ideological leaning rather than commercial and somehow incompatible with maximizing value, the line between "doing the right thing" and "doing right by shareholders" is certainly blurring if not blurred.

Yes, it rewards those that are more aligned ideologically with an ESG agenda, but to think that's where it ends is to miss the point that laws and regulations are changing in line with that ideology (for example, the U.K. government's decision to adopt a target of "net-zero" GHG emissions by 2050) and more regulation across the globe seems sure to follow. Well run businesses that can shape their own destiny and adapt to the dynamic landscape they find themselves in will surely be more likely to be successful in the long run.

In any event, whether you think ESG ratings are purely ideological or rather a logical step in making a better-informed investment decision, they do seem set to grow in popularity in the coming months.